

Notes to the Financial Statements: Fiscal Years Ended September 30, 2004 and 2003

1. Summary of Significant Accounting Policies

A. Basis of Presentation

Public Law 107-289, the Accountability of Tax Dollars Act of 2002, added the RRB as an agency required to prepare audited financial statements for fiscal year 2003 and subsequent years. OMB guidance requires that Performance and Accountability Reports (P&AR) for fiscal year 2004 are to be submitted to the President, the Congress, and the Director of OMB by November 15, 2004. As required by law, OMB has also prescribed the form and content of financial statements under OMB Bulletin 01-09. The RRB's financial statements were prepared in accordance with the form and content prescribed by OMB and with generally accepted accounting principles and standards prescribed by FASAB.

The principal statements (prepared on a consolidated basis, except for the Statement of Budgetary Resources which was prepared on a combined basis, and eliminating all significant interfund balances and transactions), are comprised of the Balance Sheet and Statements of Net Cost, Changes in Net Position, Budgetary Resources, and Financing. These statements are different from the financial reports, also prepared by the RRB pursuant to OMB directives, used to monitor and control the RRB's use of budgetary resources.

B. Reporting Entity

The railroad retirement and the railroad unemployment and sickness insurance programs are financed through the following accounts:

- Railroad Retirement Account (8011) funds retirement, survivor, and disability benefits in excess of social security equivalent benefits from payroll taxes on employers and employees and other income sources. Our authority to use these collections is 45 USC §231(F)(c)(1).
- Social Security Equivalent Benefit Account (8010) funds the portion of railroad retirement benefits equivalent to a social security benefit from various income sources related to these benefits. Our authority to use these collections is 45 USC §231N-1(c)(1).
- Dual Benefits Payments Account (0111) funds the phase-out costs of certain vested dual benefits from general appropriations. Our authority to use these collections is 45 USC §231(N)(d).
- Federal Payments to the Railroad Retirement Accounts (0113) was established by OMB and is used as a conduit for transferring certain income taxes on benefits and receiving credit for the interest portion of uncashed check transfers. This account has no basis in law.
- Limitation on Administration Account (8237) pays salaries and expenses to administer the railroad retirement program and the railroad unemployment and sickness insurance program. This account is financed by the Railroad Retirement Account, the Social Security Equivalent Benefit Account, and the Railroad Unemployment Insurance Trust Fund. Our authority to use these collections is 45 USC §231N-1(c) and 45 USC §231N-(H).

- Railroad Unemployment Insurance Trust Fund, Benefit Payments (8051.001) funds railroad unemployment and sickness insurance benefits from contributions by railroad employers. Our authority to use these collections is 45 USC §360.
- Railroad Unemployment Insurance Trust Fund, Administrative Expenses (8051.002) was established to pay salaries and expenses to administer the program. This fund is financed by contributions from railroad employers. Monies are transferred from this fund, based on cost accounting estimates and records, to the Limitation on Administration Account (8237) from which salaries and expenses are paid for both the railroad retirement program and the railroad unemployment and sickness insurance program. Our authority to use these collections is 45 USC §361.
- Limitation on the Office of Inspector General (8018) was established to fund the administration of the Inspector General's Office. Our authority to use these collections is Public Law 108-7.
- Savings Bonds Allotment (6050), and City and State Taxes (6275) were established as holding accounts for amounts withheld from employees' salaries but not yet paid to the appropriate institutions.

C. Budgets and Budgetary Accounting

Budget requests are prepared and submitted by the RRB in accordance with OMB Circular A-11 and other specific guidance issued by OMB. The RRB prepares and submits to OMB Apportionment and Reapportionment Requests (SF-132) in accordance with OMB Circular A-11 for all funds appropriated by the Congress or permanently appropriated. Although OMB may apportion funds by category, time period, or object class of expense, the RRB controls and allocates all apportioned funds by three-digit object class codes of expense. For budgetary accounting, all receipts are recorded on a cash basis of accounting and obligations are recorded against the object class codes when they are incurred, regardless of when the resources acquired are to be consumed. Obligations are amounts of orders placed, contracts awarded, services received, and similar transactions during a given period that will require payments during the same or a future period. Quarterly, the RRB prepares and submits Reports on Budget Execution (SF-133) to OMB, reporting all obligations incurred against the amounts apportioned.

D. Basis of Accounting

As required by law, the Dual Benefits Payments Account is on a cash basis of accounting. Payroll taxes and unemployment contributions are recorded on a modified cash basis in accordance with SFFAS No. 7. All other transactions are recorded on an accrual basis of accounting and a budgetary basis. Under the accrual method, revenues (except payroll taxes and unemployment contributions which are on a modified cash basis) are recognized when earned and expenses are recognized when a liability is incurred. For budgetary accounting, financial transactions are recorded when obligations are incurred, regardless of when the resources acquired are to be consumed.

The accompanying consolidated financial statements of the RRB include all funds maintained by the RRB, after elimination of all significant interfund balances and transactions.

E. Social Security Administration Payments

Under Section 7(b)(2) of the Railroad Retirement Act of 1974, the RRB is required to pay certain individuals, described in this section, monthly social security benefits on behalf of SSA. During fiscal year 2004, the RRB paid benefits on behalf of SSA (for which the RRB is reimbursed).

2. Fund Balances with Treasury

Fund balances with Treasury at September 30 consisted of:

| | 2004 | 2003 |
|---|---------------------|---------------------|
| A. Fund Balances: | | |
| (1) Trust Funds | \$26,208,366 | \$ 514,069 |
| (2) Revolving Funds | 0 | 0 |
| (3) Appropriated Funds | 12,808,550 | 12,351,942 |
| (4) Other Fund Types | 36,851 | 40,863 |
| Total | <u>\$39,053,767</u> | <u>\$12,906,874</u> |
| B. Status of Fund Balance with Treasury | | |
| (1) Unobligated Balance | | |
| (a) Available | \$12,512,020 | \$ 355,671 |
| (b) Unavailable | 430,993 | 12,134,746 |
| (2) Obligated Balance not yet Disbursed | 26,110,754 | 416,457 |
| Total | <u>\$39,053,767</u> | <u>\$12,906,874</u> |

C. Other Information: The above represents cash held in Treasury. Unobligated and obligated funds not held in cash are invested in Treasury securities.

3. Investments

The NRRIT was established pursuant to Section 105 of the RRSIA of 2001, enacted December 21, 2001. The NRRIT is to manage and invest the assets of the Railroad Retirement (RR) Account in a diversified investment portfolio in the same manner as those of private sector retirement plans. Prior to the Act, trust fund balances not immediately required for the payment of benefits could only be invested in interest bearing obligations of the United States or in obligations guaranteed as to both principal and interest by the United States as provided for in Section 15(e) of the RRA of 1974. The assets held and managed by the NRRIT are not included in the investment balances presented on the RRB's financial statements.

On September 30, 2004 and 2003, the book values of the RRB's investments, including accrued interest, totaled \$1,304,375,721 and \$1,180,997,109, respectively. The balance on September 30, 2004, consisted of \$1,302,163,000 in 3.5 percent par value specials (with market value equal to face value) maturing on October 1, 2004, and \$2,212,721 in accrued interest. The balance on September 30, 2003, consisted of \$1,179,271,000 in 3.5 percent par value specials (with market value equal to face value) maturing on October 1, 2003, and \$1,726,109 in accrued interest. Par value specials mature on the first working day of the month following the month of issue and have a yield based on the average yield of marketable Treasury notes with maturity dates at least 3 years away.

4. Accounts Receivable

- *Intragovernmental*

Accounts receivable - Intragovernmental at September 30 consisted of:

| | <u>2004</u> | <u>2003</u> |
|---|------------------------|------------------------|
| Financial Interchange – Principal | \$3,579,300,000 | \$3,569,100,000 |
| Financial Interchange – Interest | 133,000,000 | 131,200,000 |
| Department of Labor | 86,208,934 | 55,829,179 |
| Social Security Administration - OASI/DI Benefits | <u>148,705</u> | <u>239,815</u> |
| Total | <u>\$3,798,657,639</u> | <u>\$3,756,368,994</u> |

- *Accounts Receivable, Net*

Accounts receivable, net at September 30 consisted of:

| | <u>2004</u> | <u>2003</u> |
|--|---------------------|---------------------|
| Accounts receivable - Benefit overpayments | \$30,307,173 | \$34,226,497 |
| Accounts receivable – Past due RUI contributions and taxes | 298 | 2,308 |
| Accounts receivable - Interest, penalty & administrative costs | <u>414,011</u> | <u>394,315</u> |
| Total | <u>\$30,721,482</u> | <u>\$34,623,120</u> |
| Less: Allowances for doubtful accounts | <u>4,596,590</u> | <u>5,235,779</u> |
| Net Total | <u>\$26,124,892</u> | <u>\$29,387,341</u> |

The RRB's September 30, 2004, accounts receivable balance (after writing-off currently not collectible (CNC) receivables but prior to the application of the allowance for doubtful accounts) of \$30,721,482 includes \$25,233,485 (82.1%) in railroad retirement program receivables and \$5,487,997 (17.9%) in railroad unemployment insurance program receivables. The total allowance for doubtful accounts is \$4,596,590. This includes \$4,024,741 (87.6%) for the railroad retirement program and \$571,849 (12.4%) for the unemployment insurance program receivables.

The allowance for doubtful accounts for the railroad retirement program was calculated, excluding debts classified as CNC, as follows: (1) stratifying the accounts receivable into 12 categories, (2) analyzing each category using sampling and historical data, (3) determining the percentage of amounts due the RRB that would probably not be collected, (4) applying the determined percentages against accounts receivable for each category, and (5) adding the amounts derived for each category to obtain the total allowance for doubtful accounts. The allowance for doubtful accounts for the unemployment insurance program was calculated based on the ages of accounts receivable and historical information.

5. Inventory and Related Property

Operating materials and supplies are valued on the weighted average basis. The recorded values are adjusted for the results of physical inventories taken periodically. Expenditures are recorded when inventories are consumed.

6. Property and Equipment

These assets are stated at cost less accumulated depreciation/amortization. Acquisitions are capitalized if the cost is \$5,000 or more and the service life is 2 years or greater. Depreciation/amortization is computed on the straight-line method. These assets consisted of:

| Classes of Fixed Assets | Service Lives | At September 30, 2004 | | |
|---|---------------|-----------------------|--------------------------|--------------------|
| | | Cost | Accumulated Depreciation | Net Book Value |
| Structures, facilities and leasehold improvements | 15 years | \$ 2,651,787 | \$ 2,406,264 | \$ 245,523 |
| ADP software | 5 years | 19,467,854 | 19,020,477 | 447,377 |
| Equipment | 5-10 years | 5,349,732 | 4,845,002 | 504,730 |
| Internal-Use Software in Development | | 682,283 | 0 | 682,283 |
| | | <u>\$28,151,656</u> | <u>\$26,271,743</u> | <u>\$1,879,913</u> |

| Classes of Fixed Assets | Service Lives | At September 30, 2003 | | |
|---|---------------|-----------------------|--------------------------|--------------------|
| | | Cost | Accumulated Depreciation | Net Book Value |
| Structures, facilities and leasehold improvements | 15 years | \$ 2,645,463 | \$ 2,336,521 | \$ 308,942 |
| ADP software | 5 years | 19,392,205 | 18,778,452 | 613,753 |
| Equipment | 5-10 years | 5,321,911 | 4,490,183 | 831,728 |
| Internal-Use Software in Development | | 624,897 | 0 | 624,897 |
| | | <u>\$27,984,476</u> | <u>\$25,605,156</u> | <u>\$2,379,320</u> |

7. Other Assets

Other assets at September 30 consisted of:

| | 2004 | 2003 |
|--|-----------------|-----------------|
| Advances to employees for health insurance and TSP contributions | \$ 886 | \$ 950 |
| Advances for transit program | 28,515 | 28,515 |
| | <u>\$29,401</u> | <u>\$29,465</u> |

8. Liabilities

Liabilities at September 30 consisted of:

| | 2004 | 2003 |
|--|------------------------|------------------------|
| Intragovernmental: | | |
| Other - Unfunded FECA Liability | \$ 371,248 | \$ 379,250 |
| Public: | | |
| Other - Accrued Unfunded Leave | \$ 6,329,719 | \$ 6,000,721 |
| Total Liabilities Not Covered by Budgetary Resources | \$ 6,700,967 | \$ 6,379,971 |
| Total Liabilities Covered by Budgetary Resources | 4,402,936,376 | 4,373,172,237 |
| Total Liabilities | <u>\$4,409,637,343</u> | <u>\$4,379,552,208</u> |

• *Debt*

Intragovernmental debt results from borrowing from Treasury to fund benefit payments from the SSEB Account.

| | 2004 | 2003 |
|------------------------------|------------------------|------------------------|
| Beginning Balance, Principal | \$2,953,800,000 | \$2,870,200,000 |
| New Borrowing | 3,241,000,000 | 3,232,300,000 |
| Repayments | (3,232,600,000) | (3,148,700,000) |
| Ending Balance, Principal | 2,962,200,000 | 2,953,800,000 |
| Accrued Interest | 64,469,568 | 71,232,621 |
| Total | <u>\$3,026,669,568</u> | <u>\$3,025,032,621</u> |

• *Benefits Due and Payable*

Benefits due and payable are accrued for all benefits to which recipients are entitled for the month of September, which, by statute, are not paid until October. Also, liabilities are accrued on benefits for past periods that have not completed processing, such as benefit payments due but not paid. The amounts include uncashed checks of \$9,400,058 and \$8,940,462, at September 30, 2004 and 2003, respectively. Under Public Law 100-86, the amount of RRB benefits represented by checks which remain uncashed for 12 months after the check issue date are credited (including interest thereon) to the accounts from which the checks were drawn. The principal amount of uncashed checks must remain in a liability account until the RRB determines that entitlement no longer exists or another check is issued to the beneficiary.

- *Other Liabilities*

Other liabilities at September 30 consisted of:

| | 2004 | 2003 |
|--|----------------------|----------------------|
| Accrued Unfunded Liabilities | \$ 6,329,719 | \$ 6,000,721 |
| Accrued Payroll | 2,580,535 | 1,834,058 |
| Accrued RRB Contributions – TSP | 80,883 | 204,682 |
| Withholdings Payable | 23,675 | 30,806 |
| Contingent Liability (see Note 15 for details) | 172,000,000 | 172,000,000 |
| Other | (3,308) | 2,635 |
| Total | <u>\$181,011,504</u> | <u>\$180,072,902</u> |

9. Gross Cost and Earned Revenue by Budget Functional Classification - Intragovernmental

| | 2004 | 2003 |
|-----------------------------------|----------------------|----------------------|
| General Retirement and Disability | | |
| Gross Cost | \$201,251,356 | \$216,583,104 |
| Less: Earned Revenue | <u>5,693,915</u> | <u>5,259,567</u> |
| Net Cost | \$195,557,441 | \$211,323,537 |
| Unemployment Compensation | | |
| Gross Cost | \$ 4,864,915 | \$ 4,703,290 |
| Less: Earned Revenue | <u>0</u> | <u>0</u> |
| Net Cost | \$ 4,864,915 | \$ 4,703,290 |
| Total Net Cost | <u>\$200,422,356</u> | <u>\$216,026,827</u> |

10. Gross Cost and Earned Revenue by Budget Functional Classification

| | 2004 | 2003 |
|---|------------------------|------------------------|
| General Retirement and Disability | | |
| Gross Cost | \$9,302,361,438 | \$9,167,520,514 |
| Less: Earned Revenue | <u>6,353,397</u> | <u>5,805,584</u> |
| Net Cost | \$9,296,008,041 | \$9,161,714,930 |
| Unemployment Compensation | | |
| Gross Cost | \$ 133,145,015 | \$ 141,740,501 |
| Less: Earned Revenue | <u>32,758,883</u> | <u>29,899,340</u> |
| Net Cost | \$ 100,386,132 | \$ 111,841,161 |
| Net Cost Before Earned Revenues Not Attributed to Program | <u>\$9,396,394,173</u> | <u>\$9,273,556,091</u> |
| Less: Earned Revenue Not Attributed to Program | <u>71,418</u> | <u>77,808</u> |
| Total Net Costs | <u>\$9,396,322,755</u> | <u>\$9,273,478,283</u> |

11. Transfers To/From NRRIT

The NRRIT was established pursuant to Section 105 of the Railroad Retirement and Survivors' Improvement Act of 2001 that was signed into law on December 21, 2001, with an effective date of February 1, 2002. See Financial Highlights for more details pertaining to NRRIT.

In fiscal year 2004, the RRB transferred \$586 million to the NRRIT, which is in addition to the \$19.188 billion and \$1.502 billion transferred in fiscal years 2003 and 2002, respectively.

During fiscal year 2004, the NRRIT transferred a total of \$1.564 billion to the RR Account. This amount was transferred by the NRRIT for the payment of railroad retirement benefits.

12. Direct and Reimbursable Obligations

| | 2004 | 2003 |
|--------------------------|-------------------------|-------------------------|
| Direct Obligations | \$10,439,521,800 | \$28,913,179,472 |
| Reimbursable Obligations | 6,224,506 | 5,805,271 |
| Total Obligations | <u>\$10,445,746,306</u> | <u>\$28,918,984,743</u> |

13. Obligated Balance, Net, Beginning of Period

OMB determined that RUIA contributions received by the RRB directly from railroad employers should be accounted for as accounts receivable and transfers rather than revenue. As a result of this change, \$28,247,248 was moved from Federal Accounts Receivables (which increased the Obligated Balance, Net, Beginning of Period for fiscal year 2003) to Appropriations Received – Receivable (part of the Budgetary Resources). The effect of this change is that the Obligated Balance, Net, End of Period for fiscal year 2002 does not match the Obligated Balance, Net, Beginning of Period for fiscal year 2003.

14. Explanation of Material Difference Between the Statement of Budgetary Resources (SBR) and the Budget of the United States Government

A reconciliation was completed of budgetary resources, obligations incurred, and outlays, as presented in the SBR, to amounts included in the Budget of the United States Government for the year ended September 30, 2003. Reconciliation was not performed for the period ended September 30, 2004, since the RRB's Performance and Accountability Report was published in November 2004 and Treasury's MAX system will not have actual budget data until mid-December 2004. Budgetary resources, obligations incurred, and outlays were reconciled to the Program and Financing (P & F) Schedules.

A \$27 million difference was identified in the Railroad Unemployment Insurance Trust Fund (8051.001) because the gross budget authority for the Budget of the United States Government did not contain that portion of appropriated trust fund receipts collected in the current fiscal year that is precluded from obligation at year end. The RRB categorizes these funds in the SBR as funds temporarily not available pursuant to public law.

The Budget of the United States Government and the RRB's SBR differ because the Budget of the United States Government includes the gains, losses, interest/dividends earned, and transfers in and out from the NRRIT. The President's budget included \$21,943.5 million in NRRIT transactions which are not included in the financial statements of the RRB and, therefore, are not included in the RRB's SBR. The RRB has no involvement in the compilation of the NRRIT's accounting information.

15. Contingent Liabilities

The RRB is involved in the following actions:

- A transportation company filed a claim for refund of RRTA or FICA taxes paid on lump-sum separation payments on the theory that such payments were supplemental unemployment benefits. Based on a decision entered by the United States Claims Court on October 31, 2003, the RRB's legal counsel has determined that it is probable the RR and SSEB Accounts are contingently liable for an estimated amount with a range between \$90 million and \$105 million. The amount of \$90 million was recorded in fiscal year 2003 and is reflected on the fiscal year 2004 Balance Sheet under other liabilities (see note 8).
- Several Class 1 railroads are party to a suit claiming a refund of RRTA or FICA taxes paid on lump-sum separation payments on the theory that such payments are supplemental unemployment benefits. The suit has been pending the outcome of the above case. Due to the decision entered by the United States Claims Court on October 31, 2003, regarding the above case, the RRB's legal counsel has determined that it is probable that the RR and SSEB Accounts are contingently liable for an estimated amount of \$82 million. This amount was recorded in fiscal year 2003 and is reflected on the fiscal year 2004 Balance Sheet under other liabilities (see note 8).

The total amount of contingent liability recorded in fiscal year 2003 for the above two actions amounts to \$172,000,000.

- Several Class 1 railroads have filed claims for refund of taxes with the Internal Revenue Service (IRS). Based on prior experience, it is remote that the RR Account and the SSEB Account are contingently liable for an estimated amount of \$972.4 million. Under the anti-disclosure provision of the IRS code, we are not permitted to disclose any details related to these claims. No provision has been made in the accompanying financial statements regarding these claims other than this disclosure.